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SUBJECT: Canada tries to keep credit markets open as foreign bankers rebuild

Ref: Ottawa 116

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¶1. SBU) Summary: The traditional conservatism of the Canadian banking sector helped it avoid some of the damage suffered in other G-7 countries during the international financial crisis. Canada's banks have had fewer toxic assets to deal with and much higher capital reserve requirements. However, the relative strength of the Canadian banking system can do little to expedite an economic recovery that relies on events outside its borders. As Canada waits for international capital flows to improve, the central bank and finance ministry are implementing temporary measures to bridge the gaps left by the exodus of foreign banks and investors. The current challenge for Canadian authorities, however, is how to keep credit flowing even as they try to prevent dependence on government lending and minimize inflation caused by expansionary monetary policy. Recent actions by the Bank of Canada and the government to lower interest rates, institute temporary credit facilities, and introduce alternative monetary policy instruments suggest that Canadian economic officials are hoping for recovery but are prepared for further difficulties. End Summary

Canada's spring economic report card

¶2. (U) In February 2009, Bank of Canada Governor Mark Carney predicted that Canada would experience a short and shallow economic recession (reftel) even as Canadian economists outside of government were making much more pessimistic forecasts. Ottawa watchers speculated at the time that the Governor was trying to boost market confidence with a "glass half full" approach that would bolster the government's new stimulus and recovery plan.

¶3. (U) By April 23, however, the Bank of Canada had revised its outlook with a somber Monetary Policy Report that scaled-back predictions of relatively quick Canadian recovery. The April report states that monetary and fiscal policy remediation actions underway across the G-20 have been slow to take effect. Given Canada's dependence on external markets and investment, the Bank of Canada now expects the Canadian economy to shrink by 3.0 percent in 2009 (not 1.2 percent as earlier predicted), followed by 2.5 percent growth in 2010 and 4.7 percent in 2011.

Interest rate reductions

¶4. (U) On April 21, the Bank lowered its benchmark overnight lending rate by one-quarter of a percentage point to 0.25 percent - the effective lower bound for the benchmark rate. The Bank expects to hold the 0.25 overnight rate until the end of the second quarter of 2010 in order to achieve its 2 percent core inflation target. Since December 2007, the Bank has cut its benchmark rate by 425 basis points.

Quantitative easing and credit easing

¶5. (U) With the overnight lending rate technically as low as it can go, the Bank has raised the possibility of quantitative easing as an another monetary stimulus tool. The Bank is concerned that even with a 0.25 percent overnight rate, private financial institutions will continue to charge inordinately high interest rates to consumers and businesses. Quantitative easing would involve the Qconsumers and businesses. Quantitative easing would involve the purchase of government securities by the Bank of Canada with the aim of increasing the money supply and demand for other financial assets. The purchases would boost bank reserves and free up more cash for the banks to lend, the Bank hopes. (Another alternative monetary policy tool under consideration is credit easing, which would involve the purchase of private sector assets by the Bank of Canada. Such credit easing would be used to help reduce risk premiums, improve liquidity, and stimulate credit flows. With credit easing, the monetary base would remain unchanged and it is less likely than quantitative easing to exert inflationary

pressures.)

¶6. (U) While the Bank of Canada has yet to use quantitative or credit easing measures, the government's January 2009 budget included approximately $164 billion in new credit easing initiatives for businesses and consumers -- mostly deployed through governmental financial entities. The government has also created an important source of temporary credit by allowing non-exporters to tap into the Export Development Corporation (EDC) for the next two years. In late 2008, the government injected $287 million cash into EDC, and the Corporation is expected to ask Ottawa to approve an increase in their bond-funded borrowing program from $4.9 billion to $6.6 billion. Other credit-easing measures under consideration include allowing banks to enter the lucrative auto leasing market and reforms to consumer credit, such as rate ceilings and improved consumer disclosure.

The effects of the global financial crisis on Canada
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¶7. (SBU) In April 23 public comments, Bank of Canada Governor Carney stated that his earlier, optimistic economic predictions had been predicated on significant reforms in U.S., European, and Asian financial centers. Carney stated that the muted progress in re-organizing the global banking system and dealing with toxic assets has had "knock-on effects" in Canada and slowed down his country's recovery prospects. Carney said, "The longer it takes to deal with these problems, the more complicated they get and the more serious they become." Referring to the United States, Carney added, "We have had a number of conversations with the Federal Reserve and Treasury. The Geithner plans are comprehensive - the challenge is in implementation but we know that they are seized with the initiative. We and others are looking forward to progress." (Comment: It should also be noted that Canada's relatively high capital reserve requirements for its banks are having the unintended consequence of restraining lending even to blue-chip domestic borrowers. This is because of a fall in the banks's asset values, which lowers the asset-to-lending ratio rather than because of a reduction in credit. End comment.)

Planning for the morning after

¶8. (SBU) Even as the Bank of Canada injects liquidity into the economy, Bank and federal officials have begun to focus on Canada's post-crisis economic health. The Bank has been devising exit strategies to ensure that monetary stimulus does not cause undue inflation. In order to prevent EDC funds from replacing private lending, the government is requiring non-exporters to prove that they were refused credit from private lenders. Meanwhile, on the trade front, government bail-out funds (such as in the automotive sector) have been conditional upon industry restructuring to promote longer-term competitiveness.